Executive Summary[*]

In the fall of 2010, reports began to surface alleging that companies servicing $6.4 trillion in American mortgages may have bypassed legally required steps to foreclose on a home. Employees or contractors of Bank of America, GMAC Mortgage, and other major loan servicers testified that they signed, and in some cases backdated, thousands of documents claiming personal knowledge of facts about mortgages that they did not actually know to be true.

Allegations of "robo-signing" are deeply disturbing and have given rise to ongoing federal and state investigations. At this point the ultimate implications remain unclear. It is possible, however, that "robo-signing" may have concealed much deeper problems in the mortgage market that could potentially threaten financial stability and undermine the government's efforts to mitigate the foreclosure crisis. Although it is not yet possible to determine whether such threats will materialize, the Panel urges Treasury and bank regulators to take immediate steps to understand and prepare for the potential risks.

In the best-case scenario, concerns about mortgage documentation irregularities may prove overblown. In this view, which has been embraced by the financial industry, a handful of employees failed to follow procedures in signing foreclosure-related affidavits, but the facts underlying the affidavits are demonstrably accurate. Foreclosures could proceed as soon as the invalid affidavits are replaced with properly executed paperwork.

The worst-case scenario is considerably grimmer. In this view, which has been articulated by academics and homeowner advocates, the "robo-signing" of affidavits served to cover up the fact that loan servicers cannot demonstrate the facts required to conduct a lawful foreclosure. In essence, banks may be unable to prove that they own the mortgage loans they claim to own.

The risk stems from the possibility that the rapid growth of mortgage securitization outpaced the ability of the legal and financial system to track mortgage loan ownership. In earlier years, under the traditional mortgage model, a homeowner borrowed money from a single bank and then paid back the same bank. In the rare instances when a bank transferred its rights, the sale was recorded by hand in the borrower's county property office. Thus, the ownership of any individual mortgage could be easily demonstrated.

Nowadays, a single mortgage loan may be sold dozens of times between various banks across the country. In the view of some market participants, the sheer speed of the modern mortgage market has rendered obsolete the traditional ink-and-paper recordation process, so the financial industry developed an electronic transfer process that bypasses county property offices.

[*] The Panel adopted this report with a 5-0 vote on November 15, 2010.

This electronic process has, however, faced legal challenges that could, in an extreme scenario, call into question the validity of 33 million mortgage loans.

Further, the financial industry now commonly bundles the rights to thousands of individual loans into a mortgage-backed security (MBS). The securitization process is complicated and requires several properly executed transfers. If at any point the required legal steps are not followed to the letter, then the ownership of the mortgage loan could fall into question. Homeowner advocates have alleged that frequent "robo-signing" of ownership affidavits may have concealed extensive industry failures to document mortgage loan transfers properly.

If documentation problems prove to be pervasive and, more importantly, throw into doubt the ownership of not only foreclosed properties but also pooled mortgages, the consequences could be severe. Clear and uncontested property rights are the foundation of the housing market. If these rights fall into question, that foundation could collapse. Borrowers may be unable to determine whether they are sending their monthly payments to the right people. Judges may block any effort to foreclose, even in cases where borrowers have failed to make regular payments. Multiple banks may attempt to foreclose upon the same property. Borrowers who have already suffered foreclosure may seek to regain title to their homes and force any new owners to move out. Would-be buyers and sellers could find themselves in limbo, unable to know with any certainty whether they can safely buy or sell a home. If such problems were to arise on a large scale, the housing market could experience even greater disruptions than have already occurred, resulting in significant harm to major financial institutions. For example, if a Wall Street bank were to discover that, due to shoddily executed paperwork, it still owns millions of defaulted mortgages that it thought it sold off years ago, it could face billions of dollars in unexpected losses.

Documentation irregularities could also have major effects on Treasury's main foreclosure prevention effort, the Home Affordable Modification Program (HAMP). Some servicers dealing with Treasury may have no legal right to initiate foreclosures, which may call into question their ability to grant modifications or to demand payments from homeowners. The servicers' use of "robo-signing" may also have affected determinations about individual loans; servicers may have been more willing to foreclose if they were not bearing the full costs of a properly executed foreclosure. Treasury has so far not provided reports of any investigation as to whether documentation problems could undermine HAMP. It should engage in active efforts to monitor the impact of foreclosure irregularities, and it should report its findings to Congress and the public.

In addition to documentation concerns, another problem has arisen with securitized mortgage loans that could also threaten financial stability. Investors in mortgage-backed securities typically demanded certain assurances about the quality of the loans they purchased: for instance, that the borrowers had certain minimum credit ratings and income, or that their homes had appraised for at least a minimum value. Allegations have surfaced that banks may have misrepresented the quality of many loans sold for securitization. Banks found to have provided misrepresentations could be required to repurchase any affected mortgages. Because millions of these mortgages are in default or foreclosure, the result could be extensive capital losses if such repurchase risk is not adequately reserved.

To put in perspective the potential problem, one investor action alone could seek to force Bank of America to repurchase and absorb partial losses on up to $47 billion in troubled loans due to alleged misrepresentations of loan quality. Bank of America currently has $230 billion in shareholders' equity, so if several similar-sized actions – whether motivated by concerns about underwriting or loan ownership – were to succeed, the company could suffer disabling damage to its regulatory capital. It is possible that widespread challenges along these lines could pose risks to the very financial stability that the Troubled Asset Relief Program was designed to protect. Treasury has claimed that based on evidence to date, mortgage-related problems currently pose no danger to the financial system, but in light of the extensive uncertainties in the market today, Treasury's assertions appear premature. Treasury should explain why it sees no danger. Bank regulators should also conduct new stress tests on Wall Street banks to measure their ability to deal with a potential crisis.

The Panel emphasizes that mortgage lenders and securitization servicers should not undertake to foreclose on any homeowner unless they are able to do so in full compliance with applicable laws and their contractual agreements with the homeowner.

The American financial system is in a precarious place. Treasury's authority to support the financial system through the Troubled Asset Relief Program has expired, and the resolution authority created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 remains untested. The 2009 stress tests that evaluated the health of the financial system looked only to the end of 2010, providing little assurance that banks could withstand sharp losses in the years to come. The housing market and the broader economy remain troubled and thus vulnerable to future shocks. In short, even as the government's response to the financial crisis is drawing to a close, severe threats remain that have the potential to damage financial stability.